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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1930.

No. 522

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,

*Petitioner,*

*v.*

JULIA ANDREWS BRUCE,

*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

## BRIEF FOR THE RESPONDENT

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No. 522

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

## BRIEF FOR THE RESPONDENT

### PRELIMINARY STATEMENT.

The questions presented by this case and by No. 521 are identical and the respondent fully concurs in the argument contained in the brief for the respondent in No. 521. This brief is therefore confined to the presentation of additional argument and avoids repetition in so far as possible.

## OPINIONS BELOW

The opinion of the United States Circuit Court of Appeals (R. 87-88) is reported in 42 F. (2d) 197.

In all other respects the statements in the brief for the respondent in No. 521 as to the opinions below are equally applicable to this case.

## JURISDICTION

The basis for jurisdiction of this Court is correctly stated in the brief for the petitioner.

## QUESTIONS PRESENTED

The respondent concurs in the statement of the questions presented contained in the brief for the respondent in No. 521 except that the income tax asserted against the respondent in this case is for the years 1918 and 1919 only.

## STATUTES INVOLVED

The statutes involved are set forth in the Appendix to this brief.

## STATEMENT OF THE CASE

This case arises under the Revenue Act of 1918 (c.18, 40 Stat. 1057) and concerns the determination of the income tax due from the respondent for the years 1918 and 1919.

The facts are as follows:

In 1916 the respondent sold to Youngstown Sheet & Tube Company 350 shares of the capital stock of Andrews & Hitchcock Iron Company which she had acquired prior to March 1, 1913. At the same time all the other stockholders of Andrews & Hitchcock Iron Company, including the respondent's mother, Louisa Andrews, sold their shares to Youngstown Sheet & Tube Company. The aggregate number of shares outstanding and so sold was 4,000 (R. 8-9).

The purchase price was fixed by an agreement made March 11, 1916 (R. 40-42) under which Youngstown Sheet & Tube Company agreed to purchase the entire 4,000 shares and to pay therefor $2,200,000 in cash in 1916 and "as the balance of said purchase price" (R. 41) a further sum, indeterminate both as to the aggregate amount thereof and as to the time of payment. This indeterminate further sum was, pursuant to the agreement, to be computed and paid from year to year thereafter. The payment to be made each year was to be an amount equal to 60¢ per ton for each ton of iron ore to which Youngstown Sheet & Tube Company might during the year become entitled by virtue of its ownership of the capital stock of Andrews & Hitchcock Iron Company which in turn owned 12% of the capital stock of Mahoning Ore & Steel Company and was entitled by virtue of a contract between the stockholders of the latter company (R. 43-45) to receive, at cost, 12% of the output of iron ore mined annually by the latter company.

The respondent was entitled in respect of the 350 shares of stock sold by her in 1916 to receive 350/4,000ths of the purchase price.

On March 22, 1917 Louisa Andrews died and the respondent acquired by bequest from her the right to receive 550/4,000ths of the then unpaid portion of the purchase price (R. 11). The value of this right at the date of Louisa Andrews' death was fixed by the Commissioner of Internal Revenue for the purposes of the Federal estate tax at $277,164.50 (R. 11).

During each of the years 1918 and 1919 the respondent received payments both on account of the purchase price of the shares sold by her and on account of the shares sold by her mother (R. 11). The sum of the payments received by the respondent down to and including the year 1919 on account of the purchase price of the 350 shares sold by her in 1916 was less than the value on March 1, 1913 of those shares (R. 11). The sum of the payments received by the respondent down to and including the year 1919 on account of the purchase price of the 550 shares sold by her mother was less than $277,164.50 (R. 12).

The Commissioner of Internal Revenue determined that the value at March 11, 1916 of the portion of the purchase price of the entire 4,000 shares of stock of Andrews & Hitchcock Iron Company, which was to be paid from year to year subsequent to 1916, was $1,942,111.46 (R. 13). This determination was based upon the following assumptions:

> That Mahoning Ore & Steel Company had ore reserves on March 11, 1916 of 82,858,535 tons;
>
> That all of this ore would be mined;
>
> That 12% thereof would be delivered to Youngstown Sheet & Tube Company;

That, upon the foregoing assumptions, all the vendors of the stock of Andrews & Hitchcock Iron Company, and their successors in interest, would receive the sum of $5,965,814.52;

That this sum of $5,965,814.52 would be received in equal annual instalments during a period of forty-five years; and

That in order to determine the value of the unpaid portion of the purchase price, such assumed equal annual instalments should be discounted at 6%, with provision for a sinking fund at 4% (R. 13).

Upon the basis of the value thus fixed, the Commissioner determined that of every dollar received by the respondent during the years 1918 and 1919 on account of the purchase price of the 350 shares sold by her in 1916, $0.32554 represented a return of capital and $0.67446 constituted taxable income (R. 5). The Commissioner arrived at this result by dividing the sum of $5,965,814.52 by $1,942,111.46. Upon the same principles the Commissioner determined that of every dollar received by the respondent during the years 1918 and 1919 on account of the purchase price of 550 shares sold by her mother, $0.33099 represented a return of capital and $0.66901 constituted taxable income (R. 5).

The estimate of the ore reserves of Mahoning Ore & Steel Company was based upon the content of only approximately 620 acres out of approximately 1,000 acres of mineral land leased by the company (R. 12, 13). The amount of tonnage to be produced annually by the

Mahoning mine was left to the determination of the board of directors of that company (R. 12). In the proceeding before the Board of Tax Appeals it was stipulated that a difference of opinion existed between engineers and experts qualified by education and training in the iron mining industry employed by the Mahoning Ore & Steel Company, on the one hand, and by the Commissioner, on the other, as to the estimated annual production of the Mahoning mine and its life as of March 11, 1916 (R. 38-39); and that since fixing the deficiency in this case the Commissioner in a proceeding in which the depletion rate for the Mahoning Ore & Steel Company was changed, based upon data furnished by the company and the opinions of duly qualified engineers and experts employed by him, found that the life of said mine was forty years from March 1, 1913, and that the estimated ore reserves of said mine on March 1, 1913 were 88,561,533 tons (R. 39).

The respondent kept no books and her returns for Federal income tax for each of the years from 1916 to 1919, inclusive, were made on the basis of cash receipts and disbursements (R. 12).

The Board, two members dissenting in part (R. 25-26), sustained the determination of the Commissioner (R. 7-25). The Circuit Court of Appeals unanimously reversed the order of the Board of Tax Appeals and held that no part of the sums received by the respondent during the years 1918 and 1919 constituted taxable income (R. 87-88). In reaching this result, the court, as appears from its opinion in *Logan* v. *Commissioner of Internal Revenue*, 42 F. (2d) 193, discountenanced the valuation made by the Commissioner as at

March 11, 1916, and (p. 197) held that no taxable income was received until there had been a return to the taxpayer of the value as of March 1, 1913 of the shares sold by her and of the value at the time of her mother's death of the interest in the unpaid purchase price inherited by her from her mother.

## SUMMARY OF ARGUMENT

The argument which the respondent in this case proposes to make is additional to and not repetitive of that contained in the brief for the respondent in No. 521.

The respondent concurs in and has nothing to add to the argument set forth in Points I to VI, inclusive, of the brief for the respondent in No. 521 which may be summarized as follows:

1. The unpaid portion of the purchase price of the stock sold by the respondent in 1916 had no fair market value at March 11, 1916 and was not the equivalent of cash at that date. The sale of stock by the respondent on that date did not constitute an exchange of property or a closed transaction such as would establish a new "basis" for the determination of future gain or loss. The respondent therefore received no taxable income until the aggregate amount received by her exceeded the value of the stock at March 1, 1913.

2. As to the unpaid portion of the purchase price bequeathed to the respondent, she received no taxable in-

come until the aggregate amount received by her exceeded the value at which the property bequeathed was included in the gross estate for Federal estate taxation.

These propositions, if established, are of themselves sufficient to dispose of the case, but it is also true that it would seem unnecessary for this Court to pass upon the issues involved in the foregoing propositions if, as the respondent contends, no portion of the payments received by her may be subjected to tax as income until she has recovered her entire capital, whether this capital be represented by the value at March 1, 1913 of the shares sold by her, or by the value fixed by the Commissioner at March 11, 1916 upon the unpaid portion of the purchase price, or by the value fixed by the Commissioner at March 22, 1917 upon the bequest received from her mother.

The points which the respondent proposes to argue are the following:

**I. The payments received by the respondent in 1918 and 1919 constituted a return of capital, no portion of which is taxable as income and did not constitute gross income in respect of which an allowance as a deduction for exhaustion or depletion might or should be made.**

**A. "Gross income" and "gross receipts" are not synonymous. Only the excess of gross receipts over the capital recovered constitutes gross income.**

**B. Where there is uncertainty as to the ultimate recovery of capital, the proceeds of the sale, conversion or other disposition of property should be applied in reduction of the "basis" prescribed by law until the entire amount of capital has been recouped.**

**II. Even if the payments received by the respondent during 1918 and 1919 constituted in part return of capital and in part gross income, the segregation of capital from income should be made on the same basis and by the same method as those adopted by the petitioner in computing the value of the respondent's rights to receive such payments.**

For the purposes of this argument the term "capital" is used as descriptive of amounts which are exempt from taxation as income as a matter of fundamental law, or because of express statutory exemption such as the value at March 1, 1913 of property acquired prior thereto (Section 202(a) (1) of the Revenue Act of 1918) and the value of property received by bequest or inheritance (Section 213(b) (3) of the Revenue Act of 1918).

## POINT I.

**THE PAYMENTS RECEIVED BY THE RESPONDENT IN 1918 AND 1919 CONSTITUTED A RETURN OF CAPITAL, NO PORTION OF WHICH IS TAXABLE AS INCOME AND DID NOT CONSTITUTE GROSS INCOME IN RESPECT OF WHICH AN ALLOWANCE AS A DEDUCTION FOR EXHAUSTION OR DEPLETION MIGHT OR SHOULD BE MADE.**

### A.

**"Gross income" and "gross receipts" are not synonymous. Only the excess of gross receipts over the capital recovered constitutes gross income.**

Recognition of the basic distinction between "gross income", upon which Congress may, if it will, under the Sixteenth Amendment, charge the tax without allowing deductions, and "gross receipts", out of which the portion, if any, representing a return of the capital value of property sold, converted into other property or cash, or otherwise disposed of, must first be set apart before any "gross income" can arise, is essential to a clear understanding of the issue presented.

Failure to recognize the importance and controlling effect of this distinction has led the Commissioner and the Board of Tax Appeals astray in the instant case and largely accounts for such confusion and apparent conflict as exists in the decided cases in which questions similar to that here presented have arisen. Especially has

the superficial resemblance of the problem here presented to that arising in connection with the allowance of a reasonable deduction for depletion in the case of mines, led to unsound reasoning and incorrect conclusions. In fact, it is clear that this confusion lies at the root of the error in the Commissioner's determination in this matter, since it is known that the determination of the respondent's taxable income was, in the first instance, referred for consideration and computation to the Engineering Division of the Income Tax Unit, and the case has been treated throughout (except by the court below) as a case involving depletion of mining properties.

Concededly, Congress may allow or refuse to allow or may limit deductions from "gross income", as it may see fit. *New Creek Co. v. Lederer* (C. C. A. 3d), 295 Fed. 433. It may, for instance, as it has done, provide that reasonable allowances shall be made for exhaustion, depreciation, compensation paid, etc. But there is a vast difference between a *reasonable* deduction from "gross income", which Congress may allow or refrain from allowing, and the constitutional and statutory distinctions between income and return of capital. In the latter case, which is the present case, it is not sufficient that the determination be *merely reasonable*. It must be as exact as the particular facts admit of. If the question be one of deductions from "gross income", it is sufficient if it be concluded that the allowance made is reasonable in the light of all the circumstances. If the question concerns the distinction between return of capital and "gross income", the most meticulous care must be observed so as to

avoid imposing the tax upon capital. In such cases the least that is required is that the amount, if any, to be charged as income be determined with the utmost accuracy that the available facts make possible. Doubt in such cases must, on well-established principles, be resolved in favor of the taxpayer. *American Net & Twine Co.* v. *Worthington*, 141 U. S. 468, 474; *Benziger* v. *United States*, 192 U. S. 38, 55; *Gould* v. *Gould*, 245 U. S. 151; *Bowers* v. *New York & Albany Lighterage Co.*, 273 U. S. 346; *Russell* v. *United States*, 278 U. S. 181. Where no rule can be applied which will assure to the taxpayer the recovery of his capital by the time that the entire proceeds of the sale, conversion or other disposition of property have been received, as in the case of liquidating dividends, the only safe procedure is to apply "gross receipts" in reduction of capital until capital has been recovered in its entirety, and thereafter to charge all further "gross receipts" as "gross income" subject to tax.

The second point urged in the brief for the petitioner is that the payments received by the respondent "constituted gross income and a sufficient allowance for exhaustion has been made" (p. 21). It is even suggested that the entire amount of the payments should, or might have been, taxed as gross income and no allowance made for deductions (pp. 8, 21, 22). As above indicated, there is a fundamental fallacy in this approach to the question. The fallacy lies in the proposition advanced by the petitioner that where no sale is involved "annual receipts which represent the earnings of property are taxable in their entirety unless Congress makes an allowance for

exhaustion of the property" (pp. 21-22). This proposition begs the question and assumes that the amounts received by the respondent constituted earnings of property rather than the gross proceeds of the conversion of property into cash. The reasoning upon which the petitioner proceeds closely resembles that relied upon by the Solicitor General in his argument in *Doyle* v. *Mitchell*, 247 U. S. 179 which was to the effect that "gross income" is equivalent to "gross receipts", that the entire proceeds of a conversion of capital assets should be treated as gross income, and that by deducting the mere cost of assets, net income is arrived at. In its opinion in that case this Court expressly discountenanced this proposition and said (p. 184):

> "Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital. . . ."

The petitioner seeks to confine the effect of *Doyle* v. *Mitchell*, (*supra*) to cases involving the sale of property and in support of this novel theory cites *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364; *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503; *Goldfield Consol. Mines Co.* v. *Scott*, 247 U. S. 126; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103. Of the cases cited this Court in *Doyle* v. *Mitchell*, (*supra*) said with respect to the *Sargent Land Company* case and the *Goldfield Consolidated*

*Mines Company* case, which were the only cases cited which had at that date been decided (p. 188):

> "There is only a superficial analogy between this case and the case of an allowance claimed for depreciation of a mining property through the removal of minerals, since we have held that owing to the peculiar nature of mining property its partial exhaustion attributable to the removal of ores cannot be regarded as depreciation within the meaning of the act."

Although the Board of Tax Appeals in its opinion in this case fell into the same error and repeatedly referred to the payments received by the respondent as "royalties" in respect of which an allowance for depletion or depreciation should be made (R. 24) it is evident that the payments did not constitute royalties or the earnings of property but constituted the proceeds of the sale of stock or the conversion of those proceeds into cash. Both the petitioner and the Board of Tax Appeals have gone astray. It was the Board's opinion that

> "* * * a proper solution to the question of what part of the royalties received constituted taxable income lies in considering the entire amount of royalties received in a given year as includable in gross income and then in permitting a reasonable deduction therefrom in each year for the exhaustion of the contract." (R. 21)

and it rested its decision upon the erroneous conclusion that Section 213(a) of the Revenue Act of 1918 "would require all royalties received to be included in the gross income" of the respondent (R. 22).

It should be clear that we are not concerned here with "gross income" as defined in Section 213 of the Revenue Act of 1918 and deductions from gross income as authorized by Section 214 of the Act. We are concerned with the distinction between capital or principal and gross income. This is true whether the amount to be recovered by the respondent free of tax be the value of her stock at March 1, 1913 or the value of the unpaid purchase price at March 11, 1916 or the value at March 22, 1917 of the right inherited from her mother. This was the view taken by the court below in *Logan* v. *Commissioner*, (*supra*), (p. 196):

> "The Commissioner may not create income by spelling out paper profits with all the attending uncertainties which exist here and which might prevent the return of capital. The statute and the regulation referring to depletion of the mines, we think, have no application to this petitioner."

The question is whether any portion of the amounts received constituted gross income; not whether any deduction may be allowed from the gross amount thereof upon the basis of any of the specific provisions for deductions to be found in Section 214 of the Revenue Act of 1918. The petitioner in his brief (p. 22) correctly points out that the respondent had no interest in the mine nor such a relation to the mine as would entitle her to the statutory allowance for depletion and further urges that the allowance of a deduction for exhaustion which

the Board of Tax Appeals held that the respondent was entitled to was a liberal construction of the statute. But the respondent does not rely upon the statutory deductions in support of her contention that no portion of the payments constituted taxable income. Her contention is that if any portion of the amounts received constituted income, that portion was "gross income" and the remainder constituted a return of capital instead of a deduction from "gross income".

The amounts received by the respondent in 1918 and 1919 did not, as suggested by the petitioner constitute "annual receipts which represent the earnings of property" (pp. 21-22). Whether they be viewed as proceeds of the sale of personal property or as proceeds of the conversion into cash of the right to receive the payments, the result is the same. In either case the taxpayer parted with property and received cash in lieu thereof and the capital value of the thing with which she parted must be restored to her before any gain subject to tax can be realized. The situation is precisely that contemplated by this Court in *Doyle* v. *Mitchell*, (*supra*) when it said (p. 185):

> "In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

B

**Where there is uncertainty as to the ultimate recovery of capital, the proceeds of the sale, conversion or other disposition of property should be applied in reduction of the "basis" prescribed by law until the entire amount of capital has been recouped.**

Once it is recognized that the law applicable to the question presented here is not that which deals with the reasonableness of allowances authorized by Congress, but that which deals with the power or intent of Congress to tax capital, it becomes evident that the rule adopted should be one which will carve out of gross receipts with the greatest nicety and subject to the tax only that portion, if any, which clearly and beyond question constitutes income. The mass of capital must be left intact at any cost. If the cleavage cannot be made with accuracy, it should be made in such manner that no portion of capital will adhere to the portion taxed as income. It is of much less consequence from the standpoints of constitutionality and of the power and intent of Congress to levy the tax if shreds of income are left imbedded in the mass of capital and thus not presently taxed. For if the taxpayer eventually recoups his capital all further receipts will fall in for taxation, but if he fails to recoup his capital, the final result will be that capital has been taxed, however unintentionally. Such a result would be in some instances repugnant to the provisions of the Federal Constitution, and in every instance contrary to the intent of the Revenue Acts, *Lucas* v. *Alexander*, 279 U. S. 573.

If then the circumstances are such that there is no certainty that capital will be recouped, all receipts should be applied in reduction of cost until cost has been recovered. This has been the generally applied rule and it is the rule which should govern in the present case. There is no certainty that the respondent will receive her capital, nor is there any method by which the proportion of income, if any, included in each payment can be determined with precision. The conception of the Commissioner that each payment received by the respondent contains a fixed percentage of income is certainly far from the truth, and his method of apportioning can only be justified upon the basis that an apportionment *must* be made, and that any apportionment which may appear reasonable is sufficient.

The suggestion of the petitioner (Brief, p. 24) that to permit the respondent to recover her capital before any taxable gain is recognized would unduly postpone the receipt of taxable income and that if the respondent should die in the meantime a further postponement of the receipt of taxable income from the property would occur with the possible result that the Government might collect no income tax upon any of the payments is entirely beside the point. It might equally well be urged that the tax should be levied upon unrealized increment in the value of property because by passing from one person to another as the result of death such unrealized appreciation escapes taxation through becoming exempt in the hands of the person inheriting the property. The argument of the Government amounts to this: inasmuch as the postponement of taxation until the taxpayer has

received her capital may result in no gain to the Treasury, it is necessary to tax some portion of the amounts received immediately, altogether irrespective of the fact that the respondent in this instance has no certainty, owing to the many contingencies involved, of ever receiving the entire amount of her capital. The suggestion is that the taxpayer must take the chance of recovering her capital while the Government must not run any hazard of failing to collect a tax through the chance of her dying before she receives income.

It is conceded that the respondent had not, up to December 31, 1919, received in the aggregate amounts equal to the value at March 1, 1913 of the stock sold by her in 1916 (R. 11) or to the value at the date of the death of her mother of the unpaid purchase price bequeathed to her (R. 12) and it is clear from the record that she had not, up to December 31, 1919, received the value placed upon her interest in the unpaid purchase price as of March 11, 1916 by the Commissioner. The value fixed by him on her interest at March 11, 1916 was $169,934.73 (R. 5) and the amount received by her up to December 31, 1919 (exclusive of her share of the original cash payment) was $42,203.70 (R. 11) Section 202(a) (1) of the Revenue Act of 1918 excludes from gross income the value of property acquired before March 1, 1913. Section 202(a) (2) of the Revenue Act of 1918 excludes from gross income the cost of property acquired on or after March 1, 1913. Section 213(b) (3) of the Act excludes from gross income the value of property received by bequest. There is no theory upon which it can be maintained that the respondent has

received any amount in excess of her capital nor is there any certainty that she will recoup her capital out of payments to be made in the future.

In this respect the present case differs entirely from *Ruth Iron Co.* v. *Commissioner* (C. C. A. 8th) 26 F. (2d) 30; *Kosmerl* v. *Commissioner of Internal Revenue* (C. C. A. 7th) 25 F. (2d) 87, and *Platt* v. *Bowers* (S. D. N. Y.) 13 F. (2d) 951. In each of these cases the recovery of the taxpayer's capital was assured and the portion of each payment representing compensation for deferred payment and therefore income, was readily determinable. There were no contingencies as to the amounts to be received and as to the time of payment and no hazards as to the ultimate recovery of the capital, such as were recognized to exist in this case by the court below. The only cases which may be cited in which such uncertainties as to recovery of capital existed are *Eldredge* v. *U. S.*, (C. C. A. 6th) 31 F. (2d) 924 hereafter discussed and *Hitchcock* v. *Commissioner of Internal Revenue* (C. C. A. 6th) 44 F. (2d) 756 which involves the same facts as the present case and was disposed of by the Circuit Court for the Sixth Circuit upon the authority of the *Eldredge* case.

In support of the decision of the court below may be cited *Warner* v. *Walsh*, (C. C. A. 2nd) 15 F. (2d) 367; *United States* v. *Bolster*, (C. C. A. 1st) 26 F. (2d) 760; *Allen* v. *Brandeis*, (C. C. A. 8th) 29 F. (2d) 363; and *Continental Illinois Bank & Trust Company* v. *Blair*, (C. C. A. 7th) 45 F. (2d) 345 (1930).

Cases in which similar questions have been before the courts may be roughly classified into four groups:

(1) Those cases in which the question presented was distinctly confined to the reasonableness of a particular allowance for a deduction authorized by law. *Reinecke* v. *Spalding*, 280 U. S. 227; *Rosenberger* v. *McCaughn*, (C. C. A. 3d) 55 F. (2d) 699; *New Creek Co.* v. *Lederer* (*supra*).

(2) Those cases in which there was certainty as to the ultimate recovery of the capital sum involved and data was available for a precise apportionment of receipts between capital and income. *Ruth Iron Company* v. *Commissioner of Internal Revenue* (*supra*); *Kosmerl* v. *Commissioner of Internal Revenue* (*supra*); *Platt* v. *Bowers* (*supra*).

(3) Those cases in which there was uncertainty as to the ultimate recovery of capital and amounts received were applied in reduction of the statutory basis until capital had been recouped. *Warner* v. *Walsh* (*supra*); *United States* v. *Bolster* (*supra*); *Allen* v. *Brandeis* (*supra*); *Continental Illinois Bank & Trust Company* v. *Blair* (*supra*).

(4) Those cases in which it was incorrectly assumed that there was certainty as to the ultimate recovery of capital with the result that unsound results were reached in the decisions. *Eldredge* v. *United States* (*supra*); *Hitchcock* v. *Commissioner of Internal Revenue* (*supra*); *Florence L. Klein* v. *Commissioner*, 6 B. T. A. 617.

*Reinecke* v. *Spalding* (*supra*), related solely to the reasonable allowance to be made for depletion under Sec-

tion 214(a) (10) of the Revenue Act of 1918 to a lessor of mining property. In that case the question was whether the allowance made by the Commissioner was reasonable, and this Court held that the taxpayer had failed to prove it unreasonable.

*Rosenberger* v. *McCaughn* (*supra*), was a case in which it was held that the amounts received were rent or royalties and not deferred payments of purchase price, so that in sustaining the Commissioner's determination the court was in fact passing upon the reasonableness of an allowance for depletion as a deduction and not upon the question of what portion of deferred payments constituted gross income as distinguished from return of capital.

*New Creek Company* v. *Lederer* (*supra*), was a case in which the court held that the Regulations prescribed by the Secretary of the Treasury for the enforcement of the allowance for depletion under the provisions of the Revenue Act of 1916 were not unreasonable. No question of an apportionment of gross receipts between capital and income was before the court.

The *Ruth* and *Kosmerl* cases, both affirming the decision of the Board of Tax Appeals in *Ruth Iron Co.* v. *Commissioner,* 4 B. T. A. 1151, involve the same facts. In those cases the taxpayers sold mining property for forty-one equal annual payments evidenced by non-interest bearing promissory notes secured by mortgage. The number of tons in the mine was agreed to between buyer and seller and the total purchase price computed at 35 cents per ton was definitely fixed. Both the Board and the Circuit Court held that the difference between the discounted value of each note on March 1, 1913 and the

face value thereof was income at the date of payment of each note. The only element of uncertainty involved was the rate of interest used in computing the amount of the discount which was fixed by the Commissioner at 5% compounded annually as compared with 6% compounded annually with a provision for a sinking fund of 4% in the instant case.

*Platt* v. *Bowers* (*supra*), involved an agreement to pay the taxpayer $10,000 a year for fifteen years and the court held that (p. 952):

> "The amount of the discount which may be regarded as income is therefore susceptible to mathematical calculation at the legal interest rate."

The *Klein* case (*supra*), must be considered with the cases of *Warner* v. *Walsh* (*supra*), *United States* v. *Bolster* (*supra*), *Allen* v. *Brandeis* (*supra*), and *Continental Illinois Bank & Trust Company* v. *Blair* (*supra*), since all of these cases involved annuities. In the four cases last mentioned, which reflect the views of four different Circuit Courts, it was held that no taxable income was received by the annuitant until the purchase price of the annuity had been recovered. The Board of Tax Appeals, after the decision in *Warner* v. *Walsh* (*supra*), but before the decisions in the other cases cited, refused to follow *Warner* v. *Walsh* and held that the entire cost need not be returned before there was taxable gain, but that each payment was to be considered partly a return of cost and partly income. The measure of the gain derived from each payment was held by the Board to be the difference between the present worth of each

payment and the amount received. This method of determining the amount of income included in each payment is consistent with *Ruth Iron Co.* v. *Commissioner* (*supra*), but it is submitted that the conclusion in the *Klein* case was reached on the basis of false premises and analogies. It may be conceded that where there is certainty as to the ultimate recovery of capital, as in the *Ruth* and *Kosmerl* cases, some portion of each annual instalment may properly be treated as income but the Board apparently based its decision on the false assumption that a life annuitant was certain to recover his investment and in its opinion erroneously cited as analogous cases the ascertainment and recognition of gain upon the sale of lots in a subdivided tract of land and upon the sale at retail of goods purchased in bulk.

The Board's statement of the way in which present value of life annuities is arrived at and its rule for determining the taxable income included in successive instalments of an annuity are both founded on a misconception of actuarial methods. The value of a life annuity on the basis of a given age and an assumed interest rate can be determined from actuarial tables, and a value so ascertained is a proper basis for valuation because annuities and reversions are commonly bought, sold and granted upon the basis thereof. But such tables do not form a proper basis for determining the profit derived from a single annuity for the very simple reason that the tables are based on the average experience in thousands of cases, whereas taxes are levied on the actually realized experience of the taxpayer and not upon the average experience of thousands of persons of whom he is but one.

When an individual acquires a single annuity at its present value, it is impossible to say whether he will make a profit or loss until either the annuity terminates or he has recovered the principal of his investment. The Board of Tax Appeals would tax the purchaser of an annuity on a life aged 60 upon the first instalment received, on the assumption that his experience would be exactly the average of all holders of like annuities; but the tables show that more than 3% of the annuitants will die in the second year, so that more than 3% of those whom the Board would tax as having received a profit would within a year be proved to have sustained a large loss, and the same condition would exist for several more years.

The failure of the Board to recognize the uncertainty as to the recovery of his investment by a single annuitant and its failure to recognize that in the case of land or goods, where a part of the cost is allocated to the tract or portion sold, the unsold property remains as a basis for the realization of future gain or loss, whereas in the case of annuity payments there is always the possibility that the annuitant may die and the expectation of future payments out of which the investment may be recouped be partly or wholly frustrated, destroy the value of the *Klein* case as an authority.

In the present case the nature of the risks and contingencies involved differ from those involved in the case of life annuities in which the amount of the annual payments is certain but their duration uncertain. In this case both the amount and duration of the payments are uncertain, but the element of uncertainty which forms the

basis of the rule in *Warner* v. *Walsh* (*supra*), exists equally in both cases as was recognized by the court below in reversing the Board of Tax Appeals. It is worthy of note that the rule of *Warner* v. *Walsh* was that consistently followed by the Treasury Department prior to the decision in the *Klein* case and that this rule was enacted as law in the Revenue Act of 1926, Section 213(b) (2) c. 19, 44 Stat. 1974 and was reenacted as Section 22(b) (2) c. 852, 45 Stat. 791 of the Revenue Act of 1928.

Except as the Board's decision in the *Klein* case may be regarded as an authority, *Eldredge* v. *United States* (*supra*) and *Hitchcock* v. *Commissioner* (*supra*) which was decided by the same Circuit Court and rests upon the *Eldredge* case, are the only cases which may be cited for the proposition that where there is uncertainty as to the ultimate recovery of capital, some portion of each of a series of payments, uncertain as to duration or amount, may be taxed as income, before the taxpayer has recovered the capital value. Judge Mack in the *Eldredge* case seems to have taken the view that some portion of each payment should be taxed as income except in instances where there is a very high degree of uncertainty as to the ultimate recovery of capital. Such a viewpoint disregards the rule that doubts should be resolved in favor of the taxpayer and its application would inevitably lead in many instances to the taxation of capital as income. The rule adopted in the *Eldredge* case for allocating gross receipts as between capital and income is that followed by the petitioner in the instant case and seems to have been adopted on the ground of apparent

reasonableness and from a mistaken analogy to the reasonable allowance as a deduction from "gross income" for depletion in the case of mining properties rather than with due regard to the necessity of carving capital out of gross receipts in order to determine gross income. As hereafter pointed out, Judge Mack erroneously assumed that the rule for determination of income applied in *Ruth Iron Co.* v. *Commissioner* (*supra*) and in the *Klein* case could not be applied in the *Eldredge* case. The *Eldredge* case in fact rests very heavily upon the decision of the Board of Tax Appeals in the *Klein* case which it cites with approval as refusing to follow *Warner* v. *Walsh* (*supra*). Like the *Klein* case it rests upon unsound premises with regard to the certainty of recovery of the taxpayer's capital and the rule for which it appears to stand is one which should not be adopted by this Court.

Discussion of *People ex rel. Knight* v. *Lynch*, 255 N. Y. 323, which is cited by petitioner (Brief p. 29) as *contra* to *Warner* v. *Walsh* (*supra*), and as supporting the proposition that the entire amount of the payments received pursuant to the bequest is liable to tax as income, has been postponed to this point for the reason that an examination of that case discloses that the court was of the opinion that under the statutes of the State of New York it was not accurate to say that a widow, in giving up her dower, purchased an annuity and upon this ground distinguished the case from *Warner* v. *Walsh* (*supra*), *United States* v. *Bolster* (*supra*) and *Allen* v. *Brandeis* (*supra*). The court said with respect to those cases (p. 325):

> "The Appellate Division followed these decisions, stating that practical reason suggests that there should not be contradictory rules relating to the same income. We also share this feeling, but are disinclined to adopt this conclusion for the State of New York in the absence of any final construction of the statute by the United States Supreme Court. There may be a side of this question not presented to, or considered by these Circuit Courts, which we shall state and which leads us under our dower statutes to a different ruling."

Since the court held that the annuity under consideration was not a purchased annuity, it is evident that this case in no way conflicts with the proposition that a taxpayer is entitled to recover *in toto* the purchase price of a purchased annuity or the amount of a bequest falling within the principle announced by this Court in *Burnet* v. *Whitehouse* U. S. , decided April 13, 1931 before being subjected to income tax upon the proceeds thereof.

In view of the contingencies upon which the ultimate recovery of capital by the respondent in this case depends which sufficiently appear from the statement of the case it would seem that upon the authority of the decided cases as well as upon principle, the respondent should be permitted to recover her capital before being subjected to taxation rather than be obliged to run the hazard of failure to recover her capital with the result that the United States may collect the tax upon some portion thereof.

## POINT II.

**EVEN IF THE PAYMENTS RECEIVED BY THE RESPONDENT DURING 1918 AND 1919 CONSTITUTED IN PART RETURN OF CAPITAL AND IN PART GROSS INCOME, THE SEGREGATION OF CAPITAL FROM INCOME SHOULD BE MADE ON THE SAME BASIS AND BY THE SAME METHOD AS THOSE ADOPTED BY THE PETITIONER IN COMPUTING THE VALUE OF THE RESPONDENT'S RIGHTS TO RECEIVE SUCH PAYMENTS.**

If it be assumed, for the sake of argument, that the ultimate recovery of capital by the respondent is certain, and that some part of each payment should be carved out for taxation as income, it is clearly necessary, as above suggested, that the cleavage be made with the most meticulous care, and that the amount to be taxed as income be determined as accurately as the facts permit. The rule adopted by the Commissioner does not conform with this requirement. It proceeds upon a false analogy to allowances for depletion as deductions from gross income; and upon the assumption that any apparently reasonable allowance is sufficient. The truth is that the results reached by the Commissioner are flagrantly inconsistent with the process by which he has computed the amount of the respondent's capital. The Commissioner's valuations of the unpaid purchase price have been made in the manner adopted by him for the valuation of mines. He proceeds upon the assumption which is flatly contrary to the facts, that equal payments will be received by the respondent during each of forty-five years. The value fixed is the

present worth of a series of such equal payments. The tables which have been used in computing this present worth differ from compound discount tables and annuity tables in common use only in that they provide for reinvestment at a different assumed rate of interest from that which is assumed to be earned by the original investment. There is no mystery about such tables. The provision for reinvestment at a different rate of interest from that assumed to be earned by the original investment is the feature which distinguishes the Hoskold type of table from other tables. Ordinary annuity tables enable one at a glance to determine the present worth of a series of equal payments to be received over a definite future term of years at an agreed rate of interest upon the assumption that reinvestment is made at the same rate of interest. The tables used by the Commissioner perform the same office, with the added factor of providing for a return at any agreed rate of interest upon the reinvestment. The same results could be reached in each case by a laborious mathematical computation. The sum of the present worths of each future payment is the present value of the annuity and in this instance the value fixed by the Commissioner is nothing more than the sum of the present worths of the future payments which the Commissioner has assumed that the respondent will receive.

The amount of income included in each annual payment can be determined by anyone familiar with annuity tables as readily as the amount of income subjected to tax was determined in *Ruth Iron Company* v. *Commissioner* (*supra*); *Kosmerl* v. *Commissioner* (*supra*); *Platt* v. *Bowers* (*supra*) and *Klein* v. *Commissioner*

(*supra*). There is no occasion for a distinction between these cases and the present case if it be assumed that a portion of each payment constitutes income and should be taxed. The method of determining the amount of income included in each payment which was adopted by the Board of Tax Appeals in *Klein* v. *Commissioner* (*supra*), in which case it refused to follow *Warner* v. *Walsh* (*supra*), and in its decision in *Appeal of Julia Andrews Bruce* 5 B. T. A. 300, which was overruled by its decision in the present case, is identical with that applied in the *Ruth, Kosmerl,* and *Platt* cases. It is the method approved by those members of the Board who dissented from the result reached in this case.

It seems in fact peculiarly unreasonable and inequitable to determine the value of a series of payments by a process which is exact if the assumed rates of interest be accepted and in which the only element of income consists of interest computed with respect to each instalment and at the next step to determine the amount of income included in each instalment by a rule of thumb method which reaches the result that the amount of income, that is, interest, included in a payment received one year subsequent to the basic date is the same as the amount of interest included in a payment deferred forty-five years.

From the foregoing it will be immediately evident that the Circuit Court for the Sixth Circuit erred in concluding in *Eldredge* v. *United States* (*supra*), at page 929, that

> "* * * The precise method of apportionment employed in the *Klein* and *Ruth* cases is inapplicable here."

and in stating, at page 929, that

> "Reference to compound discount tables is fruitless, since the Formula involves a theoretical sinking fund to take care of the risk element, in addition to a theoretical percentage of return in the nature of interest."

The accuracy of this statement may be doubted since, in a book entitled "Principles of Valuation" by Grimes and Craigue, published in 1928, (New York, Prentice-Hall, Inc.), the authors of which appear to have been engineers in the section of the Bureau of Internal Revenue engaged in the valuation of metal mines, a formula is given by which the present worth of any one of a series of payments which have been valued in accordance with the so-called Hoskold formula may be determined. It seems that the court did not clearly apprehend the nature of the tables used. The rates of interest used were no more theoretical in one case than in the other. It is stated in the opinion, page 929, that in the *Klein* and *Ruth* cases:

> "The percentage of profit was different for each instalment, because the original capital value was calculated for each instalment solely by the discount compounded annually; the difference between such capital value and the actual payment was the taxable profit."

This is true but the introduction of an allowance for interest upon reinvestment at a different rate as an element of the computation constitutes no ground for a different treatment in this case than that which was adopted in the *Klein* and *Ruth* cases. If instead of 4% the assumed rate of interest for reinvestment had been taken at 6%, at which rate the Commissioner discounted the as-

sumed instalments, the method of computation would have been exactly that followed in ordinary annuity tables as to which the Board found no difficulty in making an allocation in the *Klein* case. Moreover, no difficulty was found in making an allocation upon the basis of the tables as a result of the decision of the Board in the overruled *Bruce* case in which the principle applied in the *Klein* and *Ruth* cases was followed.

The underlying principle of the *Klein* and *Ruth* cases was that the amount received by the taxpayer as compensation for deferment of the payments should be taxed as income when the payments fell in. Assuming that some portion of each payment is to be treated as income this is the only sound and equitable basis upon which to determine the amount which is taxable. The method adopted by the Commissioner of assigning an equal portion of each instalment to income is not only contrary to the method of valuation adopted by him but is contrary to the facts since it results in taxing as income a large percentage of the amount which any investor purchasing the payments on the basis contemplated by the Commissioner would be obliged to set apart in the earlier years as capital if the result of his bargain is to be that which the Commissioner contemplates. In other words, the petitioner insists upon valuing the unpaid purchase price here upon a basis which he maintains results in reaching its fair market value and then insists upon taxing the respondent upon a basis which, if it were made one of the conditions of the hypothetical purchase, would be so burdensome that no purchaser would contemplate making the bargain upon that basis.

## CONCLUSION.

The respondent maintains that there is no basis for the imposition of the tax sought to be collected for the years 1918 and 1919 for the reasons that she has not recovered and that there is no certainty that she will ever recover either (1) the fair market value at March 1, 1913 of the shares sold by her in 1916 or (2) the value fixed upon the unpaid portion of the purchase price by the petitioner at March 11, 1916, or (3) the value fixed by the Commissioner at March 22, 1917 upon the bequest from her mother. But if it be determined that some portion of each of the payments received by her should be taxed as income, the respondent maintains that the problem is not one of fixing upon a reasonable allowance as a deduction from gross income but involves the necessity of a precise determination of the amount of income included in each payment received by her. The petitioner urges that a rule of thumb method of making the segregation should be adopted. The respondent insists that this method is inconsistent with the Commissioner's method of valuation and is unsound and inequitable in its results. Her position is that if any portion of the payments received is to be taxed as income, that portion should comprise only the compensation for deferment of each payment which is the factor by which the Commissioner reduced the amount which he estimated to be the gross proceeds to a present worth which he calls "fair market value."

It is, therefore, respectfully submitted that the decision of the Circuit Court of Appeals in this case is correct and that its judgment should be affirmed.

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# APPENDIX.

## STATUTES INVOLVED.

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1060, 1062, 1064, 1065, 1066, 1067:

SEC. 202. (*a*) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be——

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; * * *.

SEC. 212. (*a*) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

* * * * * *

SEC. 213. That for the purposes of this title * * * the term "gross income"——

(*a*) Includes gains, profits, and income derived from * * * dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also, from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for

the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (*b*) of section 212, any such amounts are to be properly accounted for as of a different period;

(*b*) Does not include the following items, which shall be exempt from taxation under this title:

* * * * * *

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);

SEC. 214. (*a*) That in computing net income there shall be allowed as deductions:

* * * * * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar condition in each case, based upon cost including cost of development not otherwise deducted: * * *.

Revenue Act of 1926, c. 19, 44 Stat. 1974, 1982:

SEC. 213. * * *.

(b) The term "gross income" does not include the following items, which shall be exempt from taxation under this title:

* * * * * *

(2) Amounts received * * * under a life insurance endowment, or annuity contract, but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration

paid (whether or not paid during the taxable year) then the excess shall be included in gross income. * * * .

Revenue Act of 1928, c. 852, 45 Stat. 791, 797:

SEC. 22. Gross Income.

(*b*) Exclusions from gross income.—The following items shall not be included in gross income and shall be exempt from taxation under this title:

* * * * * *

(2) Annuities, etc.—Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts) under a life insurance, endowment, or annuity contract, but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration paid (whether or not paid during the taxable year) then the excess shall be included in gross income. * * *